Florida Law Review

Volume 36 | Issue 2 Article 10

March 1984

Corporations: Eviscerating Rule 10b-5 by Raising the Scienter Requirement to Specific Intent

Ross M. Goodman

CORPORATIONS: EVISCERATING RULE 10b-5 BY RAISING THE SCIENTER REQUIREMENT TO SPECIFIC INTENT

Dirks v. SEC, 103 S. Ct. 3255 (1983)

Petitioner, a securities analyst, received a call from a former vice president of an insurance company indicating that the company had inflated its value by writing fictitious insurance policies.[1] After verifying the tip,[2] petitioner informed certain large shareholders who then sold their stock to avoid substantial losses.[3] An administrative law judge determined petitioner violated Rule 10b-5[4] because he informed the shareholders knowing that they would act on the information by selling their stock.[5] Both the Securities and Exchange Commission (SEC) and the United States Court of Appeals affirmed the administrative decision.[6] On certiorari the Supreme Court reversed and HELD, Rule 10b-5 liability arises only when the recipient of inside information uses that information with the specific intent to profit by defrauding, manipulating or deceiving shareholders.[7]

---

1. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 103 S. Ct. 3255 (1983). Dirks' informant was Ronald Secrist, a former Vice President of an Equity Funding Corporation of America (EFCA) subsidiary. *Id.* at 830.

2. Dirks searched the public record, contacted others in the investment community, and interviewed present and former employees whom Secrist said would confirm the allegations. Only the employee interviews produced any tangible evidence of fraud. Dirks also interviewed some of the corporate managers who denied the allegations. *Id.*

Dirks' information also exposed a massive fraud at the parent company, EFCA, which resulted in suspended trading of EFCA's stock and ultimately in its bankruptcy. Raymond L. Dirks, 21 S.E.C. 1401, 1405-06 (1981).

3. 103 S. Ct. at 3258. The investors sold approximately $16.5 million in stock and debentures before EFCA's trading was suspended. *Id.*

4. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1983).

5. 21 S.E.C. at 1407.

6. 681 F.2d at 824.

7. 103 S. Ct. at 3260-61 (1983).

Congress promulgated the anti-fraud provisions of Rule 10b-5 in 1934 to deter the use of material, nonpublic corporate information to gain an unfair advantage in securities markets.[8] Congress did not indicate, however, whether it intended to protect only corporate shareholders by limiting the Rule's application to corporate insiders, or whether it intended to protect the investing public by extending the Rule to all potential users of inside information. This ambiguity resulted in courts applying varying standards of scienter[9] for tippee liability, ranging from specific intent to defraud shareholders[10] to mere negligent use of inside information.[11]

In *In re Cady, Roberts & Co.*, the SEC adopted the broader position that Rule 10b-5 protects the investing public from insider trading.[12] In that case, defendants profited by using information of an earnings decline to sell stock before the information reached the market.[13] The SEC rejected defendants' contention that Rule 10b-5 applies only to frauds upon existing stockholders, because this construction would leave the uninformed public wholly without protection.[14] Interpreting the Rule in light of common law concepts of fraud and fiduciary duty,[15] the SEC determined the Rule's prophylactic purpose would be served best by extending liability to any individual who knowingly uses inside information and thereby harms market participants.[16] The SEC concluded defendants violated Rule 10b-5, finding the scienter requirement satisfied because defendants

---

8. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235 (2d Cir. 1974). *See also* S. REP. No. 792, 73d Cong., 2d Sess. 18 (1934) (purpose of the Securities Exchange Act of 1934 is to regulate deceptive practices which injure investors).

9. "Scienter is a many-faceted concept, which in 10b-5 cases has encompassed states of mind ranging from an intention to deceive, to knowledge of undisclosed facts, to a reckless failure to acquire knowledge of the true facts." Bucklo, *The Supreme Court Attempts To Define Scienter Under Rule 10b-5*: Ernst & Ernst v. Hochfelder, 29 STAN. L. REV. 213, 214 (1977).

10. *See, e.g.*, Aaron v. SEC, 446 U.S. 680, 696 (1980) (brokerage firm member not liable under Rule 10b-5 for his employees' deceptive statements about a stock offering).

11. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). For a discussion of this case, see *infra* text accompanying notes 19-24.

12. 40 S.E.C. 907, 910 (1961).

13. *Id.* at 908-10.

14. *Id.* at 913.

15. *Id.* at 910-11.

16. *Id.* at 912. The SEC explained that the duty under Rule 10b-5 to disclose inside information or to refrain from trading rests on two principal elements:

> [F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id.

acted willfully.[17]

Although courts subsequently adopted the SEC's view that Rule 10b-5 protects the investing public, *Cady, Roberts'* application of a "willful," rather than a "knowing" standard fostered confusion over the requisite scienter for the Rule's violation.[18] The confusion was enhanced after *SEC v. Texas Gulf Sulphur Co.*[19] followed the policy determinations in *Cady, Roberts*,[20] but applied a negligence standard to satisfy the scienter requirement.[21] Defendants in *Texas Gulf Sulfur* were corporate insiders who capitalized on the discovery of a rich copper deposit by purchasing the corporation's securities prior to public announcement of the discovery.[22] The Second Circuit found that the defendants were persons within the scope of 10b-5.[23] The court upheld their conviction because the defendants knew or should have known they gained an unfair advantage by using the inside information.[24]

The trend toward relaxing the scienter requirement continued with the SEC's ruling in *In re Investor's Management Co.*.[25] In that case, securities dealers used inside information of a manufacturer's pending earnings decline and sold their stock to unsuspecting purchasers.[26] Favoring broad enforcement of Rule 10b-5, and recognizing the need for equal access to information in the securities markets,[27] the SEC determined defendants knew or should have known their conduct violated the Rule.[28] The SEC applied a standard of scienter

---

17. *Id.* at 917.

18. *See generally* Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 367 (1979) ("No more novel than the difficulties involved in determining when the principle is violated are the problems encountered in defining and applying the conditions determining the culpability of a violator."); Bucklo, *supra* note 9, at 214 (discussing the range of scienter requirements applied by courts under Rule 10b-5).

19. 401 F.2d 833 (2d Cir. 1968).

20. *Id.* at 847-48.

21. *Id.* at 854-55 n.21.

22. *Id.* at 843-47.

23. *Id.* at 852.

24. *Id.* at 855.

25. 44 S.E.C. 633 (1971).

26. *Id.* at 635-39.

27. *Id.* at 644.

28. *Id.* at 644-46.

> [T]he question of whether the recipient had the requisite "reason to know" is properly determinable by an examination of all the surrounding circumstances, including the nature and timing of the information, the manner in which it was obtained, the facts relating to the informant, including his business or other relation to the recipient and to the source of his information, and the recipient's sophistication and knowledge of related facts.

Id. at 644.

approaching strict liability[29] by holding that regardless of defendants' actual intent, their status as professionals in the securities market created a presumption of intent sufficient to satisfy Rule 10b-5's scienter requirement.[30]

The Supreme Court suggested an end to this trend of expansive Rule 10b-5 liability in *Ernst & Ernst v. Hochfelder*.[31] Reasoning that Congress intended Rule 10b-5 to prohibit only intentional conduct,[32] the Court conditioned liability upon proof that the defendant specifically intended to defraud the shareholders and violate 10b-5.[33] Because *Hochfelder* was a private action under Rule 10b-5, the Court reserved judgment on whether the same scienter standard would be required in SEC enforcement actions.[34]

The instant case provided the Supreme Court an opportunity to resolve the confusion over the applicable scienter standard in an enforcement action under Rule 10b-5. Although the case was ultimately decided on other grounds,[35] the instant majority embraced the *Hochfelder* view that liability attaches under the Rule only when the

---

29. Strict liability in tort is liability that attaches regardless of the tortfeasor's intent or due care. *See* RESTATEMENT (SECOND) OF TORTS § 519(1) (1977).

30. *See* 44 S.E.C. at 645.

31. 425 U.S. 185 (1976).

32. *Id.* at 214. The Court analyzed the congressional intent in enacting the Securities Exchange Act of 1934, H.R. REP. No. 85, 73d Cong., 1st Sess. 1-5 (1933), S. REP. No. 792, 73d Cong., 2d Sess. 1-5 (1934), and HEARINGS BEFORE THE SUBCOMM. ON STOCK EXCHANGE PRACTICES BEFORE THE SENATE COMM. ON BANKING AND CURRENCY, 73d Cong., 2d Sess. 6509-10 (1934), and concluded:

> Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, we think the relevant portions of that history support our conclusion that § 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone.

425 U.S. at 201. The SEC in *Cady, Roberts*, 40 S.E.C. at 912 nn.15-16, and the Second Circuit in *Texas Gulf Sulphur*, 401 F.2d at 847-48 n.9, analyzed the same record and reached the opposite conclusion. Some commentators believe the Supreme Court's different interpretation is attributable to the Court's recent tendency to limit private plaintiffs' access to the federal courts. *See* Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of* Hochfelder, 51 N.Y.U. L. REV. 769, 779 (1976).

33. 425 U.S. at 193-94 n.12.

34. *Id.* at 191-92 n.7.

35. The Court reversed the lower decisions after finding no breach of a fiduciary duty by Secrist or Dirks. The following test was applied:

> [A] tippee assumes a fiduciary duty to the shareholders of the corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

103 S. Ct. at 3264. Unlike the *Cady, Roberts* test, see *supra* note 16, the instant court's formulation does not mention the unfair trading advantage which inside information gives the possessor.

defendant had the specific intent to gain by deceiving or defrauding shareholders.[36] The majority acknowledged the Rule's prophylactic purpose,[37] but expressed concern that an overly broad scienter requirement would deter legitimate uses of inside information.[38] By contrast, a scienter standard of specific intent provides market participants a clear definition of activities proscribed by the Rule. This standard would protect shareholders without deterring insiders from legitimately disseminating material, nonpublic corporate information.[39] The majority additionally asserted that a requirement of specific intent would end the confusion over the scienter standard and foster consistent application of Rule 10b-5 liability.[40]

The dissent agreed with the majority that a fiduciary injures shareholders by profiting from inside information, but urged a more liberal scienter standard which would afford greater protection to other shareholders.[41] Considering the Rule's broad deterrent purposes,[42] the dissent posited that an individual could violate the Rule simply by failing to disclose information potentially injurious to shareholders.[43] The defendant need not actually intend to gain by deceiving shareholders because the requisite intent to injure shareholders could be inferred from breach of a fiduciary duty or from a motive to have a third party profit by the information.[44]

---

36. 103 S. Ct. at 3264. The Court cited Chiarella v. United States, 445 U.S. 222, 232 (1980), in which the Court indicated Rule 10b-5 liability does not attach without a breach by a corporate agent, fiduciary or person in whom the corporation placed its trust. 103 S. Ct. at 3261.

37. 103 S. Ct. at 3266.

38. *Id.* at 3265. The majority did not indicate its basis for defining or protecting such legitimate uses. The majority provided only one example of a disclosure of confidential inside information that would not violate Rule 10b-5: when management makes a selective disclosure mistakenly believing that the information has already been released. *Id.* Of course, the decision also reveals that securities analysts, like Dirks, may legitimately ferret out nonpublic information. *See id.* at 3263.

39. *Id.* at 3263 n.17. The Court noted: "It is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules." *Id.* at 3266.

40. *Id.* at 3266.

41. "[T]he Court imposes a new, subjective limitation on the scope of the duty owed by insiders to shareholders. The novelty of this limitation is reflected in the Court's lack of support for it." *Id.* at 3270. *See also* H. MANNE, INSIDER TRADING AND THE STOCK MARKET 62-66 (1966) (management and securities dealers have developed a "barter" system of trading information for future advantages—a method of sharing information which is difficult to detect); Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 10-11 (1980) (management and outsiders work together in order to evade detection of their activities). *But cf.* Berner & Franklin, *supra* note 32 (arguing for a requirement of specific intent for all Rule 10b-5 violations).

42. 103 S. Ct. at 3270 n.8 (Blackmun, J., dissenting).

43. *Id.* at 3270.

44. *Id.*

Although the instant decision clarifies the scienter requirement for Rule 10b-5 violations, it does so at the expense of the Rule's prophylactic functions. The difficulty of meeting this more exacting standard will result in fewer instances of 10b-5 liability. Prior decisions found the Rule's requisite scienter from the facts and circumstances surrounding the use of inside information.[45] Judicial forays into the pecuniary motivations of defendants were unnecessary for finding violations of the Rule. Under the new test, plaintiff must establish that the insider had subjective motivations for profit, and that these motivations rose to the level of a specific intent to defraud the shareholders.[46]

The Court's disregard for injuries caused by motivations other than self-aggrandizement at the corporation's expense also narrows the protection previously provided by the Rule.[47] As the dissent recognized,[48] prior courts have inferred the requisite scienter from the deleterious effects that an unfair informational advantage foisted upon uninformed market participants.[49] Rejecting this inferential approach renders the uninformed market participant easy prey for insiders who use information that benefits the insider without injuring the shareholders.[50] While broad application of the Rule led to confusion and inconsistent decisions, it provided some assurance to market participants that they dealt at a level of informational parity. Restricting the Rule's scope to one narrow class of insiders permits some market participants an informational advantage that others

---

45. *See supra* notes 29 & 30 and accompanying text. *See also* Certain Trading in the Common Stock of Faberge, Inc., 45 S.E.C. 249, 256-57 (1973) (immediacy with which defendants made purchases after receiving inside information justified an assumption that defendants knew they were violating their duty to disclose).

The difficulty of satisfying the instant court's scienter requirement may encourage violations of Rule 10b-5. *See* Dooley, *supra* note 44, at 18-19 (suggesting that many violators simply ignore the SEC rules and enforcement actions because even if prosecuted, they can usually evade liability or escape with only a mild penalty).

46. The Court suggested that specific intent to defraud may be presumed from the objective fact of some profit by the insider. *Id.* at 3266. However, the Court did not indicate whether this presumption is rebuttable. The cases and commentators reveal that a presumption of intent raises a factual issue subject to rebuttal, whether viewed from an evidentiary perspective, see Legille v. Dann, 544 F.2d 1 (D.C. Cir. 1976) (addressed the question of presuming defendant's knowledge of receipt of a patent application); *see also* FED. R. EVID. 301; C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE §§ 344-45 (2d ed. 1972); 9 J. WIGMORE, EVIDENCE §§ 2491-92, or from the perspective of statutory interpretation. *See* Furnco Constr. Corp. v. Waters, 438 U.S. 567, 578 (1978) (prima facie case of intentional discrimination under Title VII is subject to rebuttal).

47. *See supra* text accompanying note 14.

48. 103 S. Ct. at 3268 (Blackmun, J., dissenting).

49. *See supra* notes 29 & 30 and accompanying text.

50. *See, e.g., In re* Faberge, Inc., 45 S.E.C. 249 (1973).

cannot overcome.[51]

The Court's narrow application of the Rule reflects not only a desire for a clear standard, but also solicitude for protecting legitimate uses of inside information[52]—uses such as the petitioner's investigation of fraud. By failing to define the parameters of this protection, the Court has created additional potential for insider evasion of Rule 10b-5 liability. Defendants in enforcement actions can now mask illegal motivations by invoking the judicially sanctioned corporate use exception.[53] The courts' difficult task of disentangling facts is exacerabated by the absence of standards to which the facts must be applied.

In ending the confusion surrounding the scienter requirement for Rule 10b-5 liability, the instant decision eviscerates the Rule's prophylactic purpose of protecting investors from the misuse of inside information. The Court not only narrowed the Rule's range of protection but also hindered its enforcement by adopting the specific intent requirement and the vague corporate purpose exception. The Rule's limited scope and enforceability will likely decrease its deterrent value and lead to increased abuses of inside information. Solving the conflicts in the lower courts is commendable, but that solution need not have entailed emasculation of the Rule's basic purpose of protecting all market participants from unfair competition.[54]

ROSS M. GOODMAN

51. *See* Brudney, *supra* note 18, at 346 (allowing any use of inside information grants the insider a monopoly on the information that is impossible for the non-insider to either discover or overcome).

52. *See supra* note 38 and accompanying text.

53. *See* Dooley, *supra* note 44, at 10-19 (describing various deceptive practices employed in the securities markets).

54. The Court could have construed the scienter requirement to be satisfied when an individual uses inside information with the intent to injure other market participants. This broader standard could have been consistently applied by the lower courts and would have afforded protection to the investing public generally without imposing liability for legitimate corporate uses.